Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
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Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended	)	CC Docket No. 96-149
	)	
Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area	)	

REPLY COMMENTS OF THE INDEPENDENT
TELEPHONE & TELECOMMUNICATIONS ALLIANCE

By: INDEPENDENT TELEPHONE &
TELECOMMUNICATIONS ALLIANCE

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The Independent Telephone & Telecommunications Alliance ("ITTA") hereby responds to the comments submitted in the above-captioned proceeding relating to the most efficient manner to regulate independent telephone companies in their provision of in-region, interstate, interLATA telecommunications services. To support ITTA's comments, attached is an affidavit of Bruce L. Egan, Professor at Columbia University, providing the economic underpinnings of non-dominant regulation for independent telephone company offerings of interexchange services on a non-separated basis.

I. INTRODUCTION

This proceeding provides the Commission an excellent opportunity to step back and review the proper regulatory treatment of interexchange telecommunications services offered by mid-size Independent Telcos, those companies with less than two percent of the subscribed access lines nationwide, in light of the competitive development of telecommunications services markets. Nothing in the record in this proceeding disputes the simple facts that these Independent

Telcos (1) lack marketpower in the interexchange market; (2) have not (and cannot) leverage their local facilities in an anti-competitive manner against their interexchange competitors; (3) have limited financial resources; and (4) are dwarfed by Bell Operating Companies and interexchange companies with which they compete.

In light of the facts, the comments in this proceeding provide a firm foundation for the Commission to regulate Independent Telcos in their provision, on a non-separated basis, of in-region, interstate, interLATA services in the same manner it regulates AT&T, MCI and Sprint's offering of interexchange services. Notwithstanding the unfounded protestations of the interexchange carriers (IXCs), which only seek to promote their narrow self-interest to thwart competition and to gain a competitive advantage, Independent Telcos exercise little, if any, market power because of their small operating territories that are highly vulnerable to competitive entry by telecommunications giants like AT&T and MCI. As a result, there is a consensus that Independent Telcos do not have market power that justifies continued dominant carrier regulation of their integrated offering of interexchange services. *See* USTA at 4-5.

As ITTA stated in its comments, and which is supported in the record by other Independent Telcos, the Commission must regulate Independent Telcos as **non-dominant carriers** in their provision of interexchange services that are not separated from their local exchange. ITTA at 2. For example, as USTA and SNET stated, separate affiliate requirements continue to hamstring Independent Telcos with outdated and counterproductive regulatory burdens that are economically inefficient and, therefore, do not further the public interest. USTA at 9; SNET at 31. The comments also demonstrate that by regulating Independent Telcos' offering of interexchange services, which are not offered from a separate affiliate, as non-dominant, Independent Telcos will still be highly regulated compared to their competitors that provide vertically integrated services free from all dominant carrier regulation. *See* Citizens at 4-5; SNET at 20-25. This is because the exchange and exchange access services of an Independent Telcos' service offering will remain highly regulated. Thus, it is time for the Commission to provide parity between industry sectors by deregulating Independent Telcos' integrated offering of interexchange services.

II. ITTA's Members Do Not Exercise Market Power In The Relevant Geographic And Product Markets

There is a consensus in the record that Independent Telcos have no market power in the domestic, *interexchange* marketplace. *See* USTA at 3; SNET at 16. Contrary to AT&T's and MCI's unfounded assertions that Independent Telcos have "undisputed" market power in the local and exchange access markets that can be leveraged into the interexchange market, the proper market to analyze, as ITTA pointed out, and to which USTA and others supported and is consistent with Commission precedent, is the *national* interexchange services marketplace, not the local or exchange access services market. *See* AT&T at 4; MCI at 3. AT&T's, MCI's and TCG's comments are replete with possible and theoretical anticompetitive behavior in which Independent Telcos could engage because of their local exchange facilities, but are short on real evidence of any anticompetitive conduct on behalf of the Independent Telcos to justify their conclusion that the proper market to analyze to determine whether any power in the local and exchange access service markets could be leveraged anticompetitively in the interchange market. AT&T at 3-5; MCI at 5; TCG at 3.

As Professor Egan points out, it is essential to view the relevant product in any discussion of competing market power market from the types of new bundled products that competitors are offering. Affidavit of Bruce L. Egan at 6. Viewed in this light, supply and demand trends demonstrate that the relevant playing field includes a wide variety of vertically integrated telecommunications services. This comports with ITTA's comments that demonstrated, in light of the rapidly changing telecommunications marketplace, telecommunications services, as defined by the 1996 Act, is the relevant product market. ITTA at 5. ITTA recognizes, however, that this definition may be forward looking for the purposes of this proceeding. However, it is critical that the Commission analyze an Independent Telco's market power, if any, in light of the new burgeoning competition in telecommunications services.

Second, the relevant geographical market to determine whether a competitor exercises market power, as Professor Egan demonstrates, should be viewed in light of how major competitors in the relevant interexchange market (which for purposes of this exercise may be limited to interexchange services) view the consumer. Most IXCs use national mass marketing that blankets virtually all subscribers, without regard to where any particular telephone network subscriber is located or who provides their local service. Egan Affidavit at 5. As a result, the Commission should continue to analyze the market power of the Independent Telcos based on their market power in the *national*, interexchange, marketplace. Indeed, it is only AT&T and MCI that have suggested that the Commission restrict its geographic market definition in the hopes of using the regulatory system to gain a competitive advantage. As Professor Egan points out, not only do Independent Telcos lack market share, "it is simply unrealistic to believe that the competitive threat to [Independent Telcos] posed by giant nationwide market players, along with a host of other local and regional market entrants, would not provide enough market discipline to prevent an [Independent Telco] from exercising any market power." Egan Affidavit at 7. As a result, it cannot be disputed that Independent Telcos have no market power in the relevant geographic and product markets.

A. The Commission's Existing Regulatory Tools Are More than Sufficient to Safeguard Competition

The record also conclusively demonstrates that the Commission's existing regulatory tools and procedures are more than sufficient to safeguard interexchange competition and to protect against any improper leveraging of an Independent Telco's local facilities in the interexchange market. As Citizens and SNET explained, the Commission has established a series of regulatory tools to ensure that improper cross-subsidization does not occur and that LEC possible discriminatory conduct is eliminated. These tools include (1) the 1986 cost accounting rules that establish a uniform accounting system and a uniform set of cost allocation principles that all Class A LECs must use in allocating costs between access service and interstate services; (2) independent audits that attest every year that each Class A LEC's books and records conform with all applicable FCC regulations; (3) the ARMIS system that tracks a LEC's accounts over time and compares them to accounts of other LECs; (4) the nondiscriminatory provision of access to a LEC's facilities through equal access and expanded interconnection; and (5) the Commission's tariff processes and complaint procedures. SNET at 20-25; Citizens at 4-5. Moreover, the Commission implemented the first four of these regulatory tools after it had adopted the three separation requirements in the Competitive Carrier Fifth Report and Order[1],

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[1] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor,* CC Docket No. 79-252, Notice of Inquiry and Proposed Rulemaking, 77 FCC 2d 308 (1979); First Report and Order, 85 FCC 2d 1 (1980) (*"First Report and Order"*); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981) (*"Further NPRM"*); Second Further Notice of Proposed Rulemaking, FCC 82-187, 47 Fed. Reg. 17,308 (1982); Second Report and Order, 91 FCC 2d 59 (1982); Order on Reconsideration, 93 FCC 2d 54 (1983); Third Further Notice of Proposed Rulemaking, 48 Fed. Reg. 28,292 (1983); Third Report and Order, 48 Fed. Reg. 46,791 (1983); Fourth Report and Order, 95 FCC 2d 554 (1983) (*"Fourth Report and Order"*), *vacated AT&T v. FCC,* 978 F.2d 727 (D.C. Cir. 1992) *cert. denied, MCI Telecommunications Corp. v. AT&T,* 113 S.Ct. 3020 (1993); Fourth Further Notice of Proposed Rulemaking, 96 FCC 2d 1191 (1984); Fifth Report and Order, 98 FCC 2d 1191 (1984) (*Fifth Report and Order"*).

that Independent Telco must abide by in order to offer interexchange services on a non-dominant basis, thus further ensuring that LECs with control of local facilities do not improperly cross-subsidize their competitive service offerings or provide discriminatory access to their local facilities.

These regulatory tools obviate the need for further regulatory separation requirements as suggested by the IXCs. Specifically, AT&T and MCI in making such an anticompetitive suggestion, do not take into account the new and fundamentally changed market structure that the 1996 Act brought upon the local exchange and exchange access markets. As ITTA demonstrated in its comment and the Commission has recently recognized and implemented in its *Local Competition Order*,[2] Congress created an entirely new telecommunications market structure based on unleashing competition in every sector of the industry by eliminating barriers to entry. By relying on the forces of competition, Congress turned away from a regulated monopoly market structure and embraced a competitive market model to bring enormous benefits to consumers of telecommunications. This open market structure envisions a wide new range of services offered by a host of telecommunications carriers who can provide these services at the lowest cost and in the most efficient manner. As a result, the competitive market structure that Congress created is broader in scope and breath than what the Commission has traditionally envisioned in the market place. No longer will firms be limited to provide solely interexchange services, local exchange services, access services or wireless services, rather entities will provide a whole range of services. As a result, Independent Telcos do not, and cannot by definition,

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2 First Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (rel. Aug. 8, 1996).

exercise market power in their local exchange service areas that by any stretch would discriminate against their competitors in the interexchange marketplace.

B. There is No Basis in the Record for the Commission to Require Independent Telcos to Offer Interexchange Services from Structurally Separated Entities

Contrary to comments of AT&T, MCI and TCG, there is no principled basis for taking a major step backward and requiring independent LECs, in order to be classified as non-dominant in their integrated offering of interexchange services, to offer domestic, interLATA, interexchange services through separate affiliates that comply with the separate affiliate requirements of Section 272(b) of the 1996 Act. Not only is such a requirement contrary to the Congress' determination that Independent Telcos lack market power, but there is no economic justification for such a requirement.

Congress specifically recognized in the 1996 Act that Independent Telcos have a unique position in the competitive marketplace and has afforded them special treatment in light of their distinctive position. Specifically, Congress has permitted mid-size Independent Telcos to petition their State commissions for suspension or modification of certain of the 1996 Act's interconnection requirements. Section 251(f)(2). Congress acknowledged the need for this policy because a mid-size Independent Telco is in a unique position as it faces "competition from a telecommunications carrier that is a large global or nationwide entity that has financial or technological resources that are significantly greater than [its] resources." S. Rep. No. 104-23, 194th Cong., 1st Sess. 22 (1995). Even Sprint has recognized the unique position of Independent Telcos also when it stated that given the "relatively small and widely dispersed operations of the independent LECs, there is little 'payoff' to be had in the long distance market as a result of any discrimination on their part. Sprint at 4.

Indeed, there is no economic justification for implementing new quarterly reporting requirements on Independent Telcos as suggested by TCG, nor is there continued need, if interexchange services are offered on an integrated basis, for dominant carrier regulation to continue to apply with its advanced tariff review. TCG at 4. As Professor Egan points out, the primary role of economic regulation is to substitute for competition, where competition is either infeasible or otherwise unworkable. However, the use of unnecessary regulation, which is contemplated here, distorts the competitive process. The cost of unnecessary regulation are benefits of competition that are foregone. Such regulation also breeds competitors more adept at imitation than innovation -- a result that does not further the public interest. Egan Affidavit at 14.

In addition, AT&T's suggestion to continue to apply onerous advanced tariff filing requirements to Independent Telcos only provides an opportunity for it and other IXCs to gain a competitive advantage as they can analyze an Independent Telco's service offerings and react to them before they become effective, thereby gaining themselves a competitive advantage and providing disincentives for Independent Telcos to offer new and innovative services that promote competition. AT&T at 8. As a result the Commission should reject the calls to revert to a regulatory structure that does not further the public interest by inhibiting robust competition in the interexchange market place.

III. CONCLUSION

The record clearly demonstrates that Independent Telco's so-called "bottleneck" has been significantly reduced and created considerable opportunities for customers and competitors of Independent Telcos. Independent Telcos seek only the reduction of counterproductive and burdensome regulation by permitting Independent Telcos to offer interexchange services on an integrated basis as a non-dominant carrier. This proposal ensures that Independent Telcos receive the right to compete more fully and fairly so the that competition can proceed on the merits.

Respectfully submitted,

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Affidavit of Bruce L. Egan on behalf of ITTA

I. Introduction

These comments on behalf of the ITTA member companies (hereafter Mid-size LECs or MLECs) address several of the issues posed by the FCC in this NPRM within the context of answering the two primary questions raised:

(1)"...whether [the Commission] should continue to apply to independent LECs... the existing separation requirements established in the Competitive Carrier Fifth Report and Order, which are a prerequisite for independent LECs to qualify as non-dominant carriers in the provision of interstate, domestic, interexchange services originating in their local exchange areas..." (NPRM para. 108); and

(2)"...whether [the Commission] should modify [its] existing rules that require independent LECs to comply with the separation requirements... in order to qualify for non-dominant regulatory treatment in the provision of interstate, domestic interexchange services that originate in their local exchange areas"? (NPRM para. 113)

The conclusion from the analysis that follows is that separate subsidiary requirements for the provision of toll services should be lifted for the ITTA member companies (MLECs) and that non-dominant carrier status should be granted without delay.

The FCC's preliminary findings and proposed rules to retain a separate subsidiary requirement for MLECs which participate in the market for interstate interexchange services are not consistent with the realities of the new competitive market fostered by the Telecommunications Act of 1996 (the Act). Congress made clear that the overarching spirit and intent of the Act was to promote competition by empowering the FCC to engage in genuine deregulation, that is, the elimination of burdensome regulatory rules where they are no longer needed. The elimination of the separate subsidiary requirement on MLECs is a good place to start the process of genuine deregulation.

MLECs do not have market power and the FCC should practice genuine deregulation by classifying MLECs as non-dominant interstate interexchange service providers, thereby affording them the regulatory freedom and opportunity to pursue their competitive business plans.

Whether or not (or under what circumstances) the FCC ultimately finds that the separate subsidiary requirement for LEC entry into interLATA markets should be lifted for the Bell Operating Companies (BOCs), the Commission should immediately lift it for MLECs.

Given the new competitive environment, the FCC's proposal to retain the separate subsidiary requirement governing MLECs' provision of interstate interexchange service represents at best the imposition of redundant and costly regulation, and, at worst, a significant barrier to entry for those MLECs wishing to compete head to head with other unregulated players.

As this discussion reveals, the MLECs have become the industry's "forgotten middle", caught up in the continuing regulatory juggernaut designed to safeguard new market entrants from the wrath of giant incumbents like the Regional BOCs (RBOCs). Left out of this picture is a regulatory regime which is appropriate for MLECs -- too small to be a threat to the industry giants (but suffocated by regulations designed for them), yet too big to be afforded many of the regulatory protections available to the hundreds of small LECs.

II. Separation Requirements Should Be Lifted and Independent LECs Should Be Granted Non-Dominant Status

Currently, in order to qualify for non-dominant treatment, the affiliate providing interstate, interexchange services must: (1) maintain separate books of account; (2) not jointly own transmission or switching facilities with its affiliated exchange telephone company; and (3) acquire any services from its affiliated exchange telephone company at tariffed rates, terms and conditions. (NPRM para. 111)

The reason for these rules is to prevent anti-competitive control of bottleneck facilities resulting in the power to affect market prices. The relevant analytical and empirical exercise then is to determine if, in fact, MLECs would have significant control over market prices in a deregulated environment subject to market entry. It is helpful to frame the discussion as follows: 1) define market power and understand the conditions which must prevail for a firm to be able to exercise market power; 2) determine the relevant market to which the market power analysis should be applied; and 3) understand the way in which current and future competition will affect the balance of market power among competing firms.

As discussed below, any control of bottleneck facilities by MLECs is not likely in the competitive environment in which they are currently operating. This is true because, in addition to their lack of market power to instigate such control, they are also aware of the reality of their situation -- that they face a bona fide threat from any one of a number of their competitors to bypass their local network facilities.

MLECs do not have Market Power

From an economic perspective, markets will exhibit competitive behavior and firms will be unable to exercise market power if either:

1) Existing firms in the relevant market produce substitute goods or services, and the level of competition among the firms is sufficient to prevent any one firm from significantly increasing price above the competitive level for more than a transitory period; or
2) There are potential entrants to the market sufficient to prevent any one firm in the market from significantly increasing price above the competitive level for more than a transitory period.

As the discussion of potential competitive entry below demonstrates there are many likely entrants into the market, which will prevent the ILECs from increasing prices anti-competitively in the interim for fear of being cut out of the loop entirely.

The FCC was correct in its previous finding that, for purposes of defining the relevant geographic and product dimensions of the market, interstate, domestic interexchange services is a single national or international market with no relevant submarkets (NPRM para. 116, 119, 121, 122, 124). As discussed below, this has never been more applicable than in today's competitive market environment. In fact, the relevant geographic market for interexchange services extends beyond the traditional definition of interstate long distance service which was based on nothing more than an artificial jurisdictional distinction rather than a market based one. Furthermore, the relevant product market for interexchange services is the nationwide market for telecommunications services generally.

Given the pro competitive language of the Act, the FCC's elimination of separate subsidiary requirements for interstate interexchange services would serve as a signal of its intention to remove regulatory barriers to entry and allow at least some MLECs to compete on a level playing field by offering the possibility of one-stop shopping to their telephone service customers. Current rules and regulations, in particular those requiring separate subsidiaries for interexchange services, go against the grain of natural market developments. Market trends point clearly toward telecommunications firms competing in a multi-service, multimedia environment. Subscribers want it that way and therefore this is a top level condition for success in the national or global market place. And the market in question is just that -- national and global.

Relevant Geographic Market is National Market

When evaluating the potential for market power abuses in the pricing of interstate interexchange services, the magnitude of the relevant geographic market is the national market. Evidence to support this may be gleaned from observations concerning supply and demand trends. On the demand side, the primary form of advertising is national mass market advertising by giant firms. The mass market advertising blankets virtually all subscribers, usually without regard to where any particular telephone network subscriber is physically located and without regard to who their incumbent local exchange service provider might be. The only relevant marketing consideration is often the amount of interstate interexchange service one uses, and high use customers of course are the primary target of all competing carriers. Against this backdrop, the MLECs have little or no market share going in and they have no ability to leverage market power from alleged local network bottlenecks.

Real world observations supporting this proposition abound. Take the case of Sprint's national ads for $.10 per minute off peak interstate interexchange rates coast to coast. This rate applies and cannot be undermined in any way shape or form by any feasible MLEC competitive response, even within its own traditional geographic serving area. AT&T and MCI have similar national advertising strategies maximizing the use of standard nationwide pricing plans.

Relevant Product Market Includes Many Services

On the supply side of the market, all of the major long distance carriers have entered into financial and operating arrangements with local and wireless carriers to share resources and to offer one-stop shopping. These partnerships often take the form of mergers of physical and financial assets with giant national multiservice firms emerging on the scene. The trend is clear -- firms are consolidating their national presence and at the same time diversifying their product line mix all under one roof. MCI has just agreed to jointly market and provide long distance service with Nextwave, one of the largest nationwide PCS local wireless service companies. In a 14 billion dollar buyout, MFS, a major facilities-based local service provider, has just announced its merger with the 4th largest nationwide long distance carrier and one of the largest nationwide internet service providers, UUNET. AT&T is rapidly vertically integrating as well to provide nationwide one-stop shopping for local, long distance and wireless services. The same is true for major cable television companies which have teamed up with long distance carriers such as Sprint and Competitive Access Providers (CAPs) such as Teleport Communications.

The boundaries between services are continually blurring. Even on the demand side, the trend is for telecommunications companies to offer a wide range of different types of services bundled together as one telecommunications service package, sometimes even for one introductory price. Industry market surveys uniformly indicate a consumer preference for one-stop shopping for their telecommunication services For example, MCI advertises to the national mass market the availability of a wide range of services "in a box", including local, long distance, mobile and paging services. AT&T has introduced the same type of service concept and no doubt most major players will soon follow.

The trend is undeniable, the market is a national market for all major types of telecommunications services combined. Existing competitive firms are obviously hurrying to consolidate their market positions and extend their presence nationwide. In this environment of rapid industry consolidation and service diversification, about the only effect of the FCC's outdated separate subsidiary requirements will be to assure that the

MLECs will never have the opportunity to compete on a scale and scope of their rivals. For the FCC and other state regulators to continue to try to impose their contrived regulatory view of the supply and demand sides of the market on only the LECs simply raises the cost of regulation generally and, in turn, raises prices to consumers. Regulatory attempts to continue to draw bright lines of separation between types of telecommunications either by drawing artificial jurisdictional distinctions or by imposing different regulatory rules governing different narrowly defined types of services are increasingly being exposed as figments of regulation as opposed to market based distinctions. The Act provides an opportunity for regulators to pursue market based alternatives to artificial regulatory distinctions by ordering a meaningful reduction in the numerous and sometimes conflicting and overlapping regulatory rules as they apply service-by-service and carrier-by-carrier. Now it is time for the commission to effectively utilize this authority and eliminate unnecessary artificial distinctions in the way it regulates the interstate interexchange services of the MLECs.

In summary, given the known market trends, and given that the MLECs have little or no market share going in, it is simply unrealistic to believe that the competitive threat to MLECs posed by the giant nationwide market players, along with a host of other local and regional market entrants, would not provide enough market discipline to prevent an MLEC from exercising any market power. The MLEC is helpless to influence the nationwide mass market advertising campaigns of giant players and could not be expected to gain interstate toll service customers except by competing on price and service to the benefit of consumers.

III. The Telecom Act and Market Competition Ensure that Barriers to Entry are Low and Prevent MLECs from Exercising Alleged Market Power

There are already sufficient competitive safeguards in place to eliminate any need for an asymmetric separate subsidiary requirement. Imposing a costly separate subsidiary requirement on the MLECs when no such requirement is imposed on their competitors is simply regulatory overkill and a barrier to MLEC entry into the interstate interexchange market.

A competitive market is one in which there are low barriers to entry, firms are permitted to exit the market as well as enter, and there is no significant regulatory intervention over price, quality, and other terms of service. Several commenters in this proceeding point to the fact that a lack of existing competitive alternatives for basic telephone service demonstrates that incumbent LECs have market power in long distance service. The shifts in the balance of market power that will occur as a result of the Telecom Act's preemption of entry barriers and associated state and federal regulatory modifications are still unclear. MLECs are, however, particularly vulnerable to competitive entry because of their relatively small traditional service areas. Couple this with the fact that most MLECs are not vertically integrated to any significant degree into markets for long distance and cable services and it is obvious that MLECs are uniquely vulnerable to competitive entry, especially for lucrative segments of their existing local exchange service market

The environment in which MLECs operate differs in important ways from that of the Regional Bell Operating Companies (RBOCs). For example, MLECs provide little intraLATA toll service and serve a very small geographic market area surrounded by RBOCs who can pose a significant competitive threat.[1] Most experts agree that in light of the flurry of recent rulings and legislation, the U.S. is Poised for an explosion of local telecommunications competition. To understand how this local competition is likely to unfold, it is instructive to consider the development to date with local competition as well as parallels to the development of toll competition. The emergence of local competition may affect MLECs significantly and quickly, as they may have fewer of the protections that the larger local exchange companies may have. It is also important to remember that potential competition, and emerging competition, will substantially affect the current

[1] For example, BellSouth was recently granted competitive carrier status by the Florida Public Service Commission to provide local exchange service in the areas of the state in which it currently does not operate. [*Local Competition Report*, May 13, 1996, page 11].

behavior of a firm, eroding any market power that incumbent local exchange carriers might have.

Local Competition

Local competition has been developing in the U. S. for at least the past ten years. This initial development has been slow, but local competition now appears ready for rapid growth. Many competitors began as Competitive Access Providers (CAPs), providing special access to link large business customers directly to long distance companies. This situation is expected to grow rapidly after the passage of the new law. For example, in the April 15, 1996 issue of Telephony, AT&T's Chairman Robert Allen stated, "The existing local networks are not the only means of access to local customers," and announced that he already had agreements with five CAPs in 70 cities.[2]

As the regulatory environment in some states has become more favorable, many companies have entered the local exchange business, offering full, switched local exchange service as an alternative to the incumbent telephone company. Two years ago or so, this local exchange competition was permitted in only five or fewer states -- the Telecommunications Act of 1996 removed any remaining barriers to entry.

The MLECs are surrounded by 900 pound gorillas waiting to take advantage of this situation, if anything, the FCC should go out of its way to try to allow MLECs the opportunity to become more viable market players. A good start would be for the FCC to declare MLECs non-dominant thereby eliminating any separate subsidiary requirements.

Some commenters point to the experience of AT&T and state that MLECs should have to wait until there is substantial local market entry and losses of market share before being

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[2] AT&T's rather aggressive offensive into LEC markets was further highlighted in a feature in the Wall Street Journal, May 30, 1996, (B1), "AT&T Discounts Signal a National Price War."

granted non-dominant status. Such arguments are wrong for a number of reasons. Toll competition began in the U.S. in the early 1970's, but it began slowly. New long distance companies had to get regulatory approval and have the rules for competition set from the Commission for interstate service and then had to repeat this with each state regulatory agency, with varying degrees of success, for intrastate service. Typically, this intrastate service initially only included intrastate interLATA service, with intraLATA competition, if allowed at all, only approved later. On top of this protracted and expensive process, equal access was only introduced for Bell Operating Companies over a period of several years beginning in 1984. As a result, long distance competition began mostly in urban areas and for large customers and only later spread to most customers in urban and in rural areas.

But the competitive threat faced by AT&T back in 1983 cannot be comparable to what one would expect today for MLECs because AT&T's competitors were very small compared to the "900 pound gorillas" facing the MLECs today. The table below demonstrates the point by comparing AT&T's 1983 competitors to MLECs' competitors today.

Table of Selected Financial Statistics
(All Amounts in $M)

Selected AT&T Competitors in 1983

	Current Sales	Assets	MarketNet Value	Plant	EBITD
Sprint (United Tel.)	1,966	656	937	4,285	1,073
MCI	1,073	713	1,335	1,324	420

Selected LEC Competitors in 1994

	Current Sales	Assets	MarketNet Value	Plant	EBITD
AT&T	75,094	37,611	78,843	22,035	12,305
MCI	13,338	4,888	10, 878	9,059	2,609
Sprint	12,662	2,189	9,622	10,879	3,266
BellSouth	16,845	4,728	26,859	25,162	7,328
NYNEX	13,307	3,798	15,391	20,623	4,411
Bell Atlantic	13,791	3,783	21,751	16,938	3,364
Ameritech	12,570	2,891	23,725	13,455	2,147
US West	10,953	2,766	16,720	13,997	4,777
Southwestern Bell	11,619	3,493	25,052	17,317	4,952
Pacific Telesis	9,235	2,898	12,083	16,114	4,059
Time-Warner	7,396	2,817	13,323	753	1,250
TCI	4,318	204	12,421	5,579	1,685

Notes:
a)Market Value is calculated as: (number of common shares outstanding)*(1 2/3 1 closing price) (except for MCI in 1983, market value is calculated using the 3/31 closing price) b)EBITD = Earnings Before Interest, Tax and Depreciation c)Market Value for TCI is calculated using Class A common stock only d)TCI "Current Assets" is the sum of Cash and Accounts Receivable - it does not include investments in Liberty Media and other affiliates of Turner Broadcasting

Source: Company Reports-respective years, Jan. 1995 S&P Stock Guide and electronic data retrieval for 1983 prices
From G. Rosston and D. Teece, "Dynamics of the New Local Communications Markets, Competition and "Local" Communications: Innovation, Entry and Integration," *Globalism and Localism in Telecommunications*, E. Noam, ed., Amsterdam: Elsevier Science, forthcoming 1997.

Recent Toll Competition in Canada

When trying to predict what will happen in the U. S. with local exchange competition, it is informative to compare the U.S. experience with toll competition to the Canadian experience, because the Canadian experience with toll competition is more likely to give an indication of how local exchange competition will unfold in the U. S. The U.S.' early experience with toll competition stands in stark contrast to the rapid development of long distance competition in Canada. Facilities-based long distance competition was only allowed beginning in 1992. But in contrast to the U. S., equal access was implemented nationally over a very short period of time, and equal access (and the ability to offer competitive long distance service) applied to <u>all</u> long distance calls, with no equivalent to intraLATA toll calls being reserved for the incumbent local telephone company. In most of Canada, it was easy, compared to in the U. S., for long distance carriers to offer service initially to all customers—large and small, urban and rural, business and residential. In addition, U. S. competitive long distance companies were able to use experience gained in the U. S. in Canada, and this, coupled with many Canadian customers' familiarity with long distance competition in general and with specific companies in particular as a result of their exposure to U. S. advertising, resulted in a growth of long distance competition in Canada much more rapid than in the U. S. Market share losses of the incumbent Canadian telephone companies are approaching 30% after only two years, a rate of market share loss that is breathtaking by U. S. standards. Furthermore, in some geographic areas and for some segments of the market, incumbent company market share losses are even greater.

This Canadian experience may be a good indicator of how local competition will unfold in the U. S. The Telecommunications Act of 1996 removes barriers nationally, paralleling the Canadian action. Customers are already familiar with telecommunications competition, and this familiarity will make it easier to sell competitive local exchange service. Technology, including cable television and wireless, along with, perhaps, unbundling of local exchange facilities, will make entry of competitors relatively easy on a wide scale. It is certainly possible that market share losses of incumbent local exchange providers will look not like the U. S. experience in long distance but more like the Canadian experience in long distance. Beginning a year or so after a local exchange company is authorized to begin service, the time most claim it takes them to gear up to provide service, market share losses by the incumbent could increase rapidly to 30-40%, particularly in the most dense urban areas.

Economic Discussion

The issue is really one of market power: Do MLECs have sufficient market power so that regulation continues to be required? In order to address this issue, there are two key points to recognize. First, an assessment of market power will focus primarily on how firms are behaving or conducting themselves in the market and not on the structure of the market itself (for example by counting the number and size of competing firms). The number of firms and the market shares of firms will be much less instructive in assessing the actual exercise of market power than will be the conduct of the firms in the market. Second, and related to the first point, is the extent to which there are barriers to entry into the local exchange market. The absence of significant barriers to entry will go far toward insuring competitive behavior by firms in the market, and the absence of barriers to entry will effectively curtail the exercise of any market power which might appear to be present from a simple consideration of market structure.

Markets will exhibit competitive behavior and firms will be unable to exercise market power if <u>either</u> of the two following conditions holds. These conditions represent the appropriate criteria for a determination of the existence of market power.

1) Existing firms in the relevant market produce substitute goods or services, and the level of competition among the firms is sufficient to prevent any one firm from significantly increasing price above the competitive level for more than a transitory period; or
2) There are <u>potential</u> entrants to the market sufficient to prevent any one firm in the market from significantly increasing price above the competitive level for more than

a transitory period.

Market power is a matter of degree, so a more operational definition is required. In general, market power is the ability of a firm in a market to increase price in a significant, non-transitory manner over what the price would have been in a competitive market.

For interstate interexchange service, the Commission tentatively concluded that they "should treat all interstate, domestic, interexchange telecommunications as the relevant product market". The Commission also tentatively concluded that it should "evaluate an independent LEC's point-to-point markets in which calls originate in its local exchange areas separately from its markets in which calls originate outside those areas, for the purpose of determining whether an independent LEC possesses market power in the provision of in-region, interstate, domestic, interexchange services." It then goes on to list several indices, including market share, which are intended to lend some scientific weight to their presumptions.

When evaluating market power and the potential for abuses in the pricing of interstate interexchange services, it is necessary to view the situation from the marketing perspective of potential competitors. When considering their marketing of interstate interexchange services, how do competitive carriers view the market: As the MLEC's entire (traditional) service area, LATA by LATA, exchange by exchange, wire center by wire center, or do competitor's view the market as national? Do competitive carriers usually view interstate interexchange services as an exclusive service offering, or is it merely one service in a mix? Obviously, every competitor may see it differently depending on their particular niche and marketing approach. But the fact is that most major competitors see it pretty much the same - it is a national market for telecommunications services generally. To see it otherwise would be to unduly limit one's market opportunities. No artificially narrow regulatory definitions should be employed.